

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

77-6034,

77-6038, 77-6040, 77-6045, 77-6048, 77-6065

United States Court of Appeals

FOR THE SECOND CIRCUIT

In the Matter

of

WEIS SECURITIES, INC.,

Debtor.

GEORGE ALDRICH, et al.,

Appellants,

v.

EDWARD S. REDINGTON, Trustee, and
SECURITIES INVESTOR PROTECTION CORPORATION,

Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR
THE SOUTHERN DISTRICT OF NEW YORK

JOINT REPLY BRIEF FOR APPELLANTS

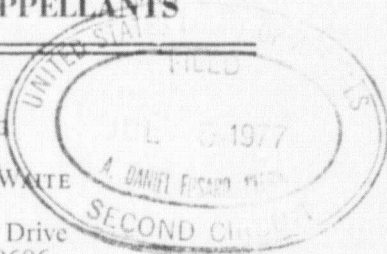
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JOINT REPLY BRIEF FOR APPELLANTS

INTRODUCTION

The Securities Investor Protection Corporation ("SIPC") has joined with the Weis Trustee in a brief in support of the decision of the District Court. The New York Stock Exchange, Inc. ("NYSE") has filed a separate brief requesting affirmance.* This

*The Securities and Exchange Commission ("SEC"), which filed an appearance in these appeals as an appellee, requested an extension of time until June 17, 1977 to file a brief. It did not file a brief within that time and had not served a brief on counsel for appellants as of the date that this brief went to the printer. Accordingly, this brief makes no reply to the SEC's brief, and appellants object to consideration of any brief the SEC may attempt to file.

Court's decision will determine whether the right of these Claimants to rescind agreements induced by Weis' fraud will be cut off for the primary benefit of members of the securities industry, through SIPC, which is funded by assessments on members of the securities industry and which would stand to gain the most by far from the loss of Claimants' right to rescind.

ARGUMENT

I. CLAIMANTS WERE ENTITLED TO RESCIND FRAUDULENTLY INDUCED AGREEMENTS EVEN THOUGH WEIS WAS A FEDERALLY REGULATED BROKER-DEALER IN LIQUIDATION UNDER SIPA.

A. The Terms of the Subordination Agreements Cannot be Enforced Because They Were Procured by Fraud.

The Trustee and SIPC repeatedly refer to the fact that the subordination agreements signed by Claimants contained terms by which Claimants agreed "irrevocably" to subordinate their claims to the claims of all other Weis creditors and to waive any right to participate in the assets of Weis' estate until the claims of all other creditors had been satisfied in full. The NYSE in its *amicus* brief also argues that Claimants cannot rescind the subordination agreements because they agreed "expressly and unambiguously in their subordination agreements that their capital would not be withdrawn prior to the maturity date of the agreement without the prior written approval" of the NYSE. (NYSE Brief at 19) Insofar as the Trustee, SIPC and NYSE are suggesting that Claimants lost their right to rescind fraudulently induced subordination agreements because of the terms of those agreements, that suggestion is clearly wrong. Rights protected by the federal securities laws may not be waived in advance. Securities Act of 1933 ("Securities Act"), §14, 15 U.S.C. §77n; Securities Exchange Act of 1934 ("Exchange Act"), §29(a), 15 U.S.C. §78cc(a). See also the cases cited in Appellants' Brief at

35-36. Moreover, it distorts common sense, as well the law, to argue that a term obtained by fraud can constitute a waiver of the fraud.

Claimants do not dispute that the terms of the subordination agreements, if lawfully procured, would bar them from rescinding. However, these subordination agreements were induced by fraud, and, as the Trustee, SIPC and the NYSE admit, Claimants ordinarily would be entitled to rescind such agreements under established principles of common law and the federal securities law. The real issue in this case involves the attempt of the Trustee and SIPC to create an exception to these legal principles based on their argument that these principles somehow do not apply in cases involving bankruptcy liquidations of companies in regulated industries. As discussed in the following sections of this brief, the right of Claimants to rescind fraudulently induced agreements is preserved even though Weis was a federally regulated broker-dealer in liquidation under the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§78aaa-78111.

B. Claimants' Right to Rescind for Fraud is Preserved in a SIPA Liquidation.

1. The *Oppenheimer* holding that a defrauded securities holder may rescind and share equally with general creditors correctly states the law.

The importance of the right to rescind a fraudulently induced agreement is such that the right persists even when the defrauding party is insolvent and in liquidation and even though rescission by the victim will mean that other, ordinarily senior, creditors will receive less in liquidation. The leading case is *Oppenheimer v. Harriman National Bank & Trust Co.*, 301 U.S. 206 (1937), where the Supreme Court held that a defrauded bank stockholder could rescind and share in the bank's assets on a parity with other unsecured creditors. 301 U.S. at 215.

The Trustee and SIPC purport to find support in *Oppenheimer*, pointing out that the *Oppenheimer* case also involved a statutory assessment against the plaintiff-shareholder as required by the National Banking Act then in force. (Appellees' Brief at 16-17) Yet that part of *Oppenheimer* and the other cases* founded on statutory language in the National Banking Act do not support the position that Claimants should be prevented from rescinding. The courts in these National Banking Act cases interpreted the clear language of the statute imposing a double assessment on bank shareholders as creating absolute liability for the amount of the statutory assessment. There is no comparable provision in the securities laws pertaining to liability of subordinated lenders to broker-dealers, and such absolute liability may not be implied. The relevant *Oppenheimer* holding is that a defrauded investor has the right to rescind in the absence of express statutory language to the contrary.

The Trustee and SIPC also dispute the applicability of the *Oppenheimer* holding — that a defrauded shareholder may rescind and share equally in the bankrupt's estate — to straight bankruptcy liquidations. (Appellees' Brief at 25-26) They apparently overlook that it has long been the "settled law in the United States that a defrauded shareholder may rescind after the insolvency of a corporation." *In re Bancunity Corp.*, 36 F.2d 595, 598 (S.D.N.Y. 1929), citing *MacNamee v. Bankers' Union for Foreign Commerce & Finance, Inc.*, 25 F.2d 614, 617 (2d Cir. 1928) and cases there cited. This rule is fully applicable when the corporation is in liquidation under the bankruptcy laws. See 3A *Collier on Bankruptcy* §63.06 at n. 23 (14th ed. 1975) and cases compiled there. Moreover, as discussed at length in our initial brief, the *Oppenheimer* rule that stockholder rescission claims rank on a parity with the claims of unsecured creditors has been explicitly recognized by courts, the SEC, commentators,

**Lantry v. Wallace*, 182 U.S. 536 (1901); *Scott v. DeWeese*, 181 U.S. 202 (1901); *Anderson v. Cronkleton*, 32 F. 2d 170 (8th Cir. 1929); *Ryan v. Mt. Vernon National Bank*, 244 F. 429 (2d Cir. 1915), all cited in Appellees' Brief at 14.

and by witnesses favoring and opposing proposed bankruptcy legislation which would change the *Oppenheimer* rule. (Appellants' Brief at 15-19)

2. Claimants' right to rescind for fraud is preserved under SIPA.

SIPA liquidations are to be conducted generally in accordance with the provisions of Chapter X* of the Bankruptcy Act, 15 U.S.C. §78fff(c), and SIPA is to be treated as an amendment to the Exchange Act, 15 U.S.C. §78bbb. The bankruptcy and securities laws expressly recognize the right to rescind, and no provision of SIPA purports either to deprive investors in or lenders to a broker of that right or to require their claims to be subordinated.

SIPA was designed to protect the customers of broker-dealers by creating a system of industry self-insurance to protect customers against the first \$50,000 of losses occasioned by broker-dealer insolvency. Brokerage firms are required to contribute to the insurance fund, which is administered by SIPC. 15 U.S.C. §78ddd. SIPC is required to make prompt payment of customer claims up to specified amounts against a broker-dealer in liquidation under SIPA without regard to whether the assets of the broker-dealer will be sufficient to reimburse it. 15 U.S.C. §78fff(f). In the Weis liquidation, SIPC is by far the largest creditor of the general estate because of the millions of dollars which it has advanced to Weis customers. Realizing that SIPC would suffer losses because of its inability to recover all of the funds which it advanced to pay customer claims, Congress provided for the replenishment of the SIPC insurance fund through additional assessments on the brokerage firms which compose SIPC's membership. 15 U.S.C. §78ddd(c). In this way, the brokerage industry itself, through SIPC, is to bear the loss resulting from broker-dealer insolvencies.

*Cf. the Trustee's and SIPC's argument that cases decided under Chapter X of the Bankruptcy Act are irrelevant to this case. (Appellee's Brief at 25-26)

By enacting SIPA, Congress did not give customer claims (or SIPC's subrogation claims) priority over the claims of other creditors with respect to the assets contained in the general estate of the bankrupt broker, nor is there any provision in SIPA which abrogates the right of Claimants under the federal securities and bankruptcy laws to rescind their subordination agreements. Contrary to the argument of the Trustee and SIPC, courts have held that investors defrauded by an insolvent broker-dealer in liquidation under SIPA could prove their fraud claims and recover from the broker-dealer's general estate. *SEC v. S. J. Salmon & Co., Inc.*, 375 F.Supp. 867, 870-71 (S.D.N.Y. 1974); *SEC v. C. H. Wagner & Co., Inc.*, 373 F.Supp. 1214, 1220 (D. Mass. 1974). The same result should be reached here.

3. Claimants' rescission claims are provable and allowable in this proceeding.

Citing this Court's decision in *In re Cartridge Television, Inc.*, 535 F.2d 1388 (2d Cir. 1976), the Trustee and SIPC also argue that the "contingent and unliquidated" fraud claims of Claimants "are not necessarily provable and may not be allowable in bankruptcy or SIPA liquidations because they will delay and frustrate other creditors."* (Appellees' Brief at 27) This argument is based on Section 57(d) of the Bankruptcy Act, 11 U.S.C. §93(d), which provides in relevant part that an "unliquidated or contingent claim shall not be allowed . . . if the court shall determine that it is not capable of liquidation or of reasonable estimation or that such liquidation or estimation would unduly delay the administration of the estate or any proceeding under this title." That section does not bar Claimants here since their claims are not "contingent and unliquidated", their claims are capable of reasonable estimation without undue delay, and since courts have

*The Trustee's and SIPC's sudden concern with unnecessary litigation delaying the liquidation of Weis' estate is somewhat ironic in light of the years that they have spent in the courts objecting to the claims of these Claimants.

specifically held that this kind of fraud claim is provable and allowable in bankruptcy.

Numerous cases have held that fraud claims of the type asserted by Claimants here are provable in bankruptcy on a quasi-contractual basis, despite the general rule that tort claims are not provable. In *SEC v. C. H. Wagner & Co., Inc.*, 373 F.Supp. 1214, 1220 (D. Mass. 1974), a SIPA liquidation case, the court overruled the argument of the trustee that fraud claims were not provable and specifically held that such claims were provable as quasi-contractual claims against the debtor's general estate. See also *SEC v. S. J. Salmon & Co., Inc.*, 375 F.Supp. 867, 870-71 (S.D.N.Y. 1974), another SIPA liquidation case, and 3A *Collier on Bankruptcy* §63.25 at 1894-95 (14th ed. 1975) and the cases compiled there at n. 16.

The claims of Claimants are not "unliquidated" in the sense that further proceedings are needed to ascertain the amount of such claims. By rescinding their subordination agreements, Claimants assert claims only for the amount of funds and securities which they advanced to Weis; the amount of these claims — approximately \$8 million — is undisputed. (Appellees' Brief at 5; see also A273-A278) It is also undisputed that Claimants have a valid claim against Weis for that amount. The Trustee's Application dated April 23, 1974 admitted that the claims of Weis' subordinated lenders were allowable, although in a subordinated capacity. (Appellees' Brief at 5; Record Document No. 26 at 2) In other words, only the *priority* of these claims is "contingent" upon the outcome of this litigation; their *allowability* is not in issue.

Moreover, as this Court noted in the *Cartridge Television* case, the allowability of claims under Section 57(d) of the Bankruptcy Act is largely up to the discretion of the bankruptcy judge, although it might well be an abuse of discretion to reject an easily provable securities fraud claim. 535 F.2d at 1391. Bankruptcy Judge Babitt never found that the claims of Claimants should

be disallowed, and this Court should not make such a determination in the first instance, especially when there is no evidence in the record to suggest that these claims are not capable of reasonable estimation or that such estimation would cause undue delay. To the contrary, in view of the magnitude of Weis' fraud in this case, where five of Weis' principal officers were indicted, convicted (four on guilty pleas) and sentenced on various charges of criminal violations of the securities laws (*United States v. Arthur Levine, et al.*, No. 73 Crim. 693, in the United States District Court for the Southern District of New York), the contention that Claimants' fraud claims are too contingent and too remote to be allowable borders on the frivolous.

C. Claimants Are Not Estopped From Rescinding by the NYSE's Net Capital Rule.

The primary argument advanced by the Trustee and SIPC in this litigation is that Claimants are estopped from rescinding their subordination agreements with Weis because other creditors of Weis relied on such agreements. In order to avoid the need of proving such reliance, the Trustee and SIPC argue that such reliance must "be conclusively presumed to exist for reasons of public policy" since the subordination agreements were required as part of a regulatory scheme for the protection of creditors. (Appellees' Brief at 13) Specifically, the Trustee and SIPC point to the NYSE's net capital rule and argue that Claimants' subordinated loans enabled Weis to appear to comply with the net capital rule and that Weis would not have been permitted to remain in business but for the fact that it appeared to be in compliance with that rule. (Appellees' Brief at 19-22) This argument does not justify the estoppel of Claimants since (1) actual reliance by other creditors is a necessary element of estoppel; (2) reliance cannot be presumed from the operation of the NYSE's net capital rule; (3) no estoppel is possible in this case since Claimants did not participate in, nor have knowledge of, Weis' fraud; and (4) public policy considerations do not support the estoppel of Claimants.

1. Actual reliance by other creditors is a necessary element of estoppel.

In order to establish an estoppel defense, the law of estoppel clearly requires that the party asserting the estoppel must have relied to his injury on conduct of the party to be estopped. *E.g.*, *Hampton v. Paramount Pictures Corp.*, 279 F.2d 100, 104 (9th Cir.), *cert. denied*, 364 U.S. 882 (1960). Since the defenses of waiver and estoppel are strongly disfavored in securities law cases, *Fox v. Kane-Miller Corp.*, 398 F.Supp. 609, 624 (D. Md. 1975), it is especially important that actual reliance be shown before an estoppel may be asserted in such cases. *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1050 (7th Cir. 1974); *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568, 570 (9th Cir. 1964).

These principles also require a showing of actual reliance by senior creditors before subordinated lenders can be estopped from asserting fraud claims justifying rescission. The applicable law was stated by this Court in *In re Credit Industrial Corp.*, 366 F.2d 402 (2d Cir. 1966), which was discussed at length in our previous brief. (Appellants' Brief at 39-42) This Court there stated two holdings: First, that parties may bind themselves to a *lawfully procured* subordinated agreement which is enforceable in bankruptcy without regard to proof of reliance; second, that where the subordination agreement is *unlawful*, "it may be reasonable and necessary, if equity is to be done, to require a senior creditor to prove that he relied on the subordination agreement." 366 F.2d at 409. The Trustee and SIPC assert that this Court's statement in the *Credit Industrial* case that proof of reliance may be necessary was not a holding of the case. (Appellees' Brief at 23-24) Yet their reading of the *Credit Industrial* case cannot be correct, for this Court did not simply grant summary judgment in favor of the senior creditors, but rather held that the dismissal before trial of the subordinated lenders' fraud claims was error and required a remand to "await such disposition as the law and facts require after the relevant facts have been developed." 366 F.2d at 412. See also *Aixala v. W. E. Hutton & Co.*, [1974-1975 Transfer

Binder] Fed. Sec. L. Rep. (CCH) §94,981 (S.D.N.Y. 1975) and *In re Joe Newcomer Finance Co.*, 226 F.Supp. 387 (D. Colo. 1964), cases upholding the right to rescind or reform fraudulently induced subordination agreements in the absence of proof that third party creditors relied on such agreements.

2. Reliance cannot be presumed from the operation of the NYSE's net capital rule.

Unable or unwilling to prove actual reliance on Claimants' loans by other creditors of Weis as required by the above cases, the Trustee and SIPC seek to avoid their burden of proof by arguing that such reliance must "be conclusively presumed to exist" because of the operation of the net capital rule. (Appellees' Brief at 13, 19-22) The reasoning underlying this argument is explained by the NYSE as follows. Creditors of Weis relied not on Claimants' subordinated loans, but on the NYSE's enforcement of Weis' compliance with the net capital rule. The NYSE, in turn, relied on the subordination agreements in satisfying itself that Weis was in compliance with the rule. Had Weis appeared not to be in compliance with the rule, it would have been suspended and could not have received additional extensions of credit. (NYSE Brief at 12-16) This argument must fail because it is based on unfounded factual assumptions and because its reasoning is faulty.

As discussed in Claimants' initial brief, the Trustee's and SIPC's "presumed reliance" argument depends on a number of unproven factual premises, such as the alleged reliance of Weis' customers and creditors on the NYSE's enforcement of the net capital rule and the assertion that Claimants made their loans to allow Weis to comply with the rule. (Appellants' Brief at 26-27) Another crucial factual assumption is that the NYSE would have required Weis to cease operations for noncompliance with the net capital rule — an assumption which is questionable at best. In a letter dated January 12, 1971 from SEC Commissioner Hugh F. Owens to Congressman Harley O. Staggers, printed in *Hearings before the Subcomm. on Commerce and Finance of the House Comm. on*

Interstate and Foreign Commerce, 92nd Cong., 1st Sess. 52-58 (1971), Commissioner Owens described several instances where "the NYSE relaxed the interpretation and enforcement of its net capital rule in order to avoid placing a number of firms in violation . . ." *Id.* at 54. Similarly, the Senate Securities Industry Study concluded that "the NYSE at times 'interpreted' its net capital rule in such a way as to permit member organizations to remain in business despite what would otherwise be considered violations of the rule." *Report of the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93rd Cong., 1st Sess. 29 (1973). It thus appears that there was no assurance that the NYSE would have closed Weis' doors to the public if it had become aware of Weis' noncompliance with the net capital rule at an earlier date.

The actions taken by the NYSE* when it belatedly learned of the gravity of Weis' financial condition cast further doubt on its willingness to have required Weis to cease operations because of a net capital rule violation. In April and May of 1973, after the NYSE was informed that Weis had been seriously understating its operating losses in its financial reports, the NYSE did not take immediate action to stop Weis' operations. Instead, in an effort to keep Weis in business, the NYSE actively encouraged Weis to solicit additional subordinated loans** and to merge with another brokerage firm. Weis was thereby permitted to continue in business, and to incur additional customer and other liabilities, for a number of weeks after the NYSE knew that it was in violation of the net capital rule. This record provides no basis for granting the Trustee's summary judgment motion based on his argument

*The NYSE's actions taken after it learned that Weis had been filing false financial reports are briefly described in this Court's opinion in *Rich v. New York Stock Exchange*, 522 F.2d 153, 156 (2d Cir. 1975).

**If the NYSE had required Weis to cease business operations in mid-April 1973, Robert E. Slater, one of the Claimants herein, would not have purchased a subordinated note from Weis in the amount of \$500,000 on May 7, 1973. (A221-A230)

that the NYSE would not have allowed Weis to continue operating but for the existence of Claimants' subordinated loans.

The "presumed reliance" argument must also fail because its reasoning cannot withstand close analysis. For example, in their attempt to find an apparently nonculpable party to enforce the fraudulently procured subordination agreements, the Trustee and SIPC turn to the NYSE (Appellees' Brief at 36-39) because the law requires that a party seeking to assert an estoppel be itself free of fault. See *C. F. Lytle Co. v. Clark*, 491 F.2d 834, 838 (10th Cir. 1974); *Rayonier, Inc. v. Polson*, 400 F.2d 909, 918 (9th Cir. 1968). However, in this case, the NYSE's alleged reliance cannot be a predicate for enforcing Claimants' subordination agreements because of the NYSE's own failures in regard to Weis.

As the NYSE has itself explained, it was responsible for supervising Weis and insuring Weis' compliance with the various statutes and rules governing brokerage firms. Its responsibilities included regular and close review of Weis' financial condition. (NYSE Brief at 9-16) To carry out its responsibilities for the protection of Weis' customers and creditors, including Claimants, the NYSE had access to all of Weis' records and extensive power to examine and review Weis' condition. If anyone had the opportunity, the capacity and the duty to discover and disclose Weis' problems, it was the NYSE. Yet despite all of the sources of information and verification tools available to it, the NYSE did not detect or disclose the gross fraud which Weis perpetrated upon Claimants, as well as upon other Weis customers and creditors.

The argument advanced by the Trustee and SIPC attempts to somehow place the responsibility for the NYSE's failure to shut Weis down for noncompliance with the net capital rule on Claimants' subordinated loans. But the NYSE did not fail to uncover Weis' fraud because of anything Claimants did. There was no defect in Claimants' loans which caused Weis to fail to comply with the net capital rule. Rather, the Weis liquidation was brought

on by large losses, disguised by completely fictitious entries in Weis' books and records, which were unrelated to Claimants' loans. (See Morrison Affidavit, A21-A42) Moreover, the Trustee's and SIPC's argument ignores the overriding effect of Weis' fraud — which all parties have conceded for purposes of this motion. Weis appeared to comply with the net capital rule (while violating it in reality) because of its fraudulent alterations of the figures in its financial statements. The impact of Weis' fraud, which adversely affected Claimants as well as other creditors, was exacerbated by the failure of Weis' independent auditors to detect the gross misstatements in Weis' financial statements and by the failure of the regulatory bodies charged with supervising Weis to uncover Weis' fraud.

In other words, the fact that Claimants advanced securities and funds to Weis on a subordinated basis was not the proximate cause of Weis' apparent compliance with the net capital rule which permitted Weis to continue operating. There were too many supervening causes — Weis' fraud, the failure of the independent accountants to detect the fraudulent alterations of Weis' financial statements and the failure of the SEC and the NYSE to uncover Weis' fraud — to justify making an exception to the established rule that actual reliance by other creditors on the subordinated loans is required before Claimants can be estopped from rescinding the fraudulently induced agreements.

Finally, Claimants dispute the dire predictions of the Trustee, SIPC and NYSE that the effectiveness of the net capital rule in assuring the financial responsibility of broker-dealers will be eviscerated if Claimants are allowed to exercise their right to rescind for fraud. Claimants agree that, absent fraud, subordination agreements should be enforced in liquidations. Yet it is neither necessary nor equitable to enforce agreements procured by the fraudulent misrepresentations of a broker-dealer. Broker-dealer fraud can better be remedied by deterring and uncovering such fraud through vigorous enforcement of the civil and criminal penalties in the securities laws, independent and thorough audits of broker-dealer

financial statements, and close surveillance of broker-dealers by the SEC and self-regulatory organizations than by eliminating the right to rescind of defrauded investors.

3. No estoppel is possible in this case since Claimants did not participate in, nor have knowledge of, Weis' fraud.

An estoppel may be asserted only if the party to be estopped had full knowledge of the facts. An estoppel may not be asserted against a party where crucial information was fraudulently concealed from the party against whom the estoppel is asserted. *Andrews v. Blue*, 489 F.2d 367, 375 (10th Cir. 1973). See also the cases cited in Appellants' Brief at 36-38. Since Claimants in this case did not know about Weis' fraud or Weis' true financial condition, they cannot be estopped from rescinding.

The Trustee and SIPC rely on a number of cases* in support of their contention that reliance by individual creditors need not be shown in regulated industries such as banking and insurance where the promise or agreement sought to be enforced is required as part of a regulatory scheme for the protection of creditors. Yet those cases are easily distinguishable from this case since the parties against whom estoppel was invoked were active participants in schemes to defraud. The scheme was the same in every instance. A note or other debt instrument was given without consideration in order to create a false picture of the recipient's assets for the purpose of deceiving bank examiners or insurance commissioners. When sued on the notes, the makers, who were participants in the fraud, attempted to invoke a defense of no consideration. All were estopped, on far different facts than exist here.

The legal result is quite different when the party sought to be

**D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942); *Hurd v. Kelly*, 78 N.Y. 588 (1879); *Best v. Thiel*, 79 N.Y. 15 (1879); *Ashton v. Glaze*, 95 F.2d 427 (9th Cir. 1938), cited in Appellees' Brief at 12-18.

estopped does not participate in and has no knowledge of any fraud. In *FDIC v. Meo*, 505 F.2d 790 (9th Cir. 1974), an investor executed a promissory note to a bank but never received the consideration for which he had bargained. The promissory note remained an asset of the bank until it became insolvent. The bank's receiver, the FDIC, argued that the investor was estopped from invoking the defense of no consideration, citing *D'Oench, Duhme & Co. v. FDIC*, *supra*, which the Trustee and SIPC also rely upon here. The Ninth Circuit rejected FDIC's argument that at case and its progeny stand for the proposition that a purchaser of bank stock is estopped from avoiding his investment regardless of his innocence simply because his investment was part of the bank's assets. The court refused to estop a party who was not negligent and did not participate in any wrongdoing, holding that where ordinary and good faith transactions are involved, the FDIC as receiver succeeds only to the rights which the bank acquired. 505 F.2d at 793. See also *Deitrick v. Standard Surety and Casualty Co.*, 303 U.S. 471, 479-80 (1938); *Andresen v. Kaercher*, 38 F.2d 462 (8th Cir. 1930).

The Trustee and SIPC also cite a number of cases (see Appellees' Brief at 31-34) which assertedly provide authority for their contention that the securities laws do not support rescission in this case. It is highly significant, however, that in *none* of those cases was an innocent party who had made a timely demand to rescind a fraudulently induced securities transaction estopped or otherwise barred from rescinding. Indeed, in one of the cases cited by the Trustee and SIPC, the court discussed cases upholding an estoppel defense of securities law claims and noted that the defense had been successfully asserted only when the party to be estopped had taken action inconsistent with rescission "*after the acquisition of knowledge.*" *Junker v. Midterra Associates*, 49 F.R.D. 310, 313 (S.D.N.Y. 1970). (Emphasis supplied.) In a subsequent appeal of another case cited by the Trustee and SIPC, the court specifically refused to apply the equitable doctrines of waiver and estoppel to an innocent purchaser of securities who

was without knowledge of the material facts. *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568 (9th Cir. 1964).

4. Public policy considerations do not support the estoppel of Claimants.

The Trustee and SIPC specifically invoke "reasons of public policy" to support their argument that Claimants should be estopped from rescinding. (Appellees' Brief at 13) In its memorandum submitted below, the SEC took the position that: "In the case of customers, the specific statutory policy of protecting customers through the financial responsibility requirements overrides the more general policy of providing redress for victims of securities fraud . . ." (Supplemental Designation of Record on Appeal, item 3 at 13)* The NYSE also argues on policy grounds that the "consequence of permitting claimants to rescind would be to eliminate subordination agreements as a source of capital for the brokerage industry and thereby jeopardize the financial stability of stock brokerage firms." (NYSE Brief at 8)

These policy arguments should be addressed to Congress rather than to this Court. In the Congressional hearings cited in our initial brief (Appellants' Brief at 17-18), Congress recently considered, but did not enact, a proposed amendment to the bankruptcy laws which would have explicitly subordinated rescission claims to other claims in bankruptcy. Substantial arguments were presented at the hearings in favor of and against the proposed amendment. It is the duty of Congress to weigh the various policy arguments and to determine whether the proposed amendment, which would significantly alter existing law, should be enacted. Until Congress so acts, the law is as stated in the common law, the federal securities acts and in *Oppenheimer* — defrauded investors may rescind

*With respect to non-customer creditors, the SEC memorandum supports our position that Claimants should be allowed to rescind and share equally with such creditors. *Id.*

their investments and share in the bankrupt's estate on a parity with other creditors.

Another deficiency in the policy arguments advanced by the Trustee, SIPC, the NYSE and SEC is that they are based on predictions of what would happen if Claimants were allowed to rescind without any factual foundation in the record for such predictions, let alone the kind of undisputed facts which would be required to sustain a motion for summary judgment. As discussed above, Claimants dispute their dire predictions that the financial responsibility of broker-dealers would be undermined if Claimants are allowed to exercise their right to rescind for fraud. With respect to the NYSE's argument that the financial stability of the brokerage industry would be adversely affected if Claimants are permitted to rescind, it seems more reasonable to believe that the opposite result would occur—that the flow of subordinated capital to brokerage firms would be severely curtailed if the right of subordinated lenders to rescind for fraud were eliminated. In any event, the factual assumptions underlying these policy arguments can neither be proved nor disproved without the introduction of evidence to flesh out the skimpy record in this case.

If this court were to consider policy, it must take into account the substantial policy considerations which favor the preservation of Claimants' right to rescind for fraud. The strong policies in favor of permitting innocent victims to rescind fraudulently induced transactions are established both in the common law and in the federal securities laws. (Appellants' Brief at 11-14) The importance of providing an effective remedy for violations of the securities laws has been recognized, *e.g.*, *J. I. Case Co. v. Borak*, 377 U.S. 426, 433 (1964), and the courts have carefully guarded the right of innocent victims of securities fraud to rescind. *E.g.*, *Gordon v. Burr*, 506 F.2d 1080, 1083-85 (2d Cir. 1974). Since Claimants are innocent victims of Weis' fraud just as other creditors of Weis are, principles of equity and fairness require that

Claimants be allowed to rescind and share in Weis' estate on a parity with such other creditors.*

II. THE NYSE ACQUIRED NO INDEPENDENT RIGHT TO PREVENT RESCISSION BY CLAIMANTS.

The Trustee and SIPC argue that Claimants are bound by direct promises made to the NYSE that their loans were and would be "unconditionally subordinated" to claims of Weis' general creditors and customers, that the NYSE has independent rights pursuant to those promises, and that the Trustee and SIPC may enforce the promises on behalf of Weis' customers and creditors who were third party beneficiaries of those promises. (Appellees' Brief at 36-37) This argument is not properly before the Court, is not supported by the record, and is not valid as a matter of law.

A. The Argument Is Not Properly Before the Court.

As a threshold matter, this Court should decline to consider the argument that Claimants made independently enforceable promises to the NYSE. Although the District Court referred to the Bankruptcy Court's rejection of this contention, the District Court itself clearly did not pass on the point. (425 F.Supp. at 214; A413) Accordingly, since the District Court has not ruled on the issue, this Court should not undertake review. See *EEOC v. Standard Forge and Axle Company, Inc.*, 496 F.2d 1392 (5th Cir. 1974), *cert. denied*, 419 U.S. 1106 (1975).

Moreover, appellees have failed to preserve in this Court any right they may have had for review of the issue. The Civil Appeal Pre-Argument Conference Order entered in these appeals on March 16, 1977 required lead counsel for appellants to notify all counsel of issues planned to be raised and further required all other counsel to notify lead counsel of any additional issues

*Under SIPA, of course, public customers of Weis are entitled to receive up to \$50,000 each from the insurance fund maintained by SIPC. Their right to such payments would not be affected by Claimants' rescission.

planned to be raised. By letter of April 7, 1977, lead counsel advised all counsel of the issues planned to be raised, and certain other counsel raised additional issues which were circulated to all counsel in a letter dated April 25, 1977. The Trustee and SIPC never advised that they intended to raise the issue they have now discussed in their answering brief. In view of their disregard of the orderly procedure established by the March 16, 1977 Order and their indifference to the Court's instructions, this Court should decline to consider the argument.

B. There Is No Evidence that Claimants Made Agreements with or Promises Directly to the NYSE.

On the merits of the issue, the Trustee's and SIPC's argument is either that Claimants made independent agreements with the NYSE (Appellees' Brief at 36-37), or that independent promises made to the NYSE are enforceable under the doctrine of promissory estoppel. (Appellees' Brief at 38) In either form, the argument first requires a finding that Claimants made agreements with or promises directly to the NYSE. Further, since this appeal is from a decision on a summary judgment motion, it would be necessary, to sustain the Trustee's and SIPC's position, to find that the evidence so clearly established the promises or agreements that there is no genuine issue as to any material fact, even viewing the record and inferences drawn from it in the light most favorable to Claimants. See, *e.g.*, *Shibarger v. United Aircraft Corp.*, 381 F.2d 808, 809-10 (2d Cir. 1967); F.R.Civ.P. 56(c).

The Bankruptcy Court's holding was clear and unequivocal:

"There is no evidence of any contractual agreement between the subordinated lenders and the Exchange." (A386)

The District Court did not disturb this finding, and the Trustee and SIPC have failed to point to anything in the record which shows the finding to be reversible error. That portion of the brief filed by the Trustee and SIPC which deals with their contentions is remarkably devoid of record references. (See Appellees' Brief

at 36-39) Moreover, it is highly significant that the NYSE — the alleged promisee — does not argue in its brief that Claimants made agreements with or independent promises to it.

In fact, there is no evidence of agreements with or promises to the NYSE. The only agreements and promises in the record are among the Claimants and Weis, and the NYSE is not a party to any of them. (A43-A230) There are no separate agreements among Claimants and the NYSE, and in none of the agreements among Claimants and Weis is there any provision which purports to be a promise running directly to the NYSE. All of the promises contained in the agreements are expressed as being among Claimants and Weis, and not as with the NYSE. In addition, in response to the Trustee's motion for summary judgment, Claimants specifically denied the existence of contracts with or promises to the NYSE, and those denials were not controverted. (See A319-A343, A348-A371)

The Trustee's and SIPC's argument thus fails at the outset for lack of any evidence of promises to the NYSE. Each of the authorities cited at page 36 of Appellees' Brief, which stand for the proposition that a party who is the promisee of a direct and independent promise made to it may enforce its independent rights, is based upon the existence of a separate and independent promise made to the party seeking enforcement. In this case, where no such independent promises were made, the NYSE acquired no independent right to prevent rescission by Claimants.

C. Even if the NYSE Were a Promisee, It Did Not Acquire an Independent Right of Enforcement.

Even assuming that the NYSE could somehow be found to be a promisee of Claimants' agreements with Weis to subordinate their loans, there is nothing in the record to suggest that Claimants assumed a separate obligation to the NYSE which could be enforced regardless of the fact that the contracts were voidable as against Weis. It is undisputed that Claimants would not have

made promises to anyone to advance funds and securities to Weis on a subordinated basis but for Weis' fraudulent procurement of the subordination agreements. The agreements themselves do not expressly give the NYSE an independent right (see A43-A230), and no independent right can be inferred from them.

Claimants' promise of subordination was single and indivisible, and performance could not be rendered to the NYSE separately from Weis. Any right which the NYSE and Weis had to enforce performance of Claimants' promise was a joint right. See *St. Regis Paper Co. v. Stuart*, 214 F.2d 762, 766 (1st Cir. 1954), *cert. denied*, 348 U.S. 915 (1955); *Nabors v. Texas Co.*, 28 F.Supp. 694, 697-98 (W.D. La. 1938); *Restatement of Contracts* §128. Where obligees of a promise have a joint right, a discharge as to one obligee operates as a discharge of the joint right of all obligees. See *Oliphant v. New York Yankees, Inc.*, 42 Misc. 2d 394, 248 N.Y.S.2d 350 (1964); 4 *Corbin on Contracts* §941 (1951); 2 *Williston on Contracts* §343 (3d ed. 1959); *Restatement of Contracts* §130. Any right of Weis to enforce Claimants' promises of subordination is unenforceable because of Weis' fraud (admitted for purposes of this case), and therefore any right the NYSE could have had is also discharged.

D. The Trustee and SIPC May Not Enforce Alleged Promises to the NYSE.

The foregoing discussion demonstrates that Claimants made no independent promises to the NYSE which the NYSE could enforce. Here, of course, the NYSE is not the party seeking enforcement of its alleged rights as a promisee. The Trustee and SIPC purport to represent customers and creditors as alleged third party beneficiaries of agreements with or promises to the NYSE.*

*Insofar as the argument is that Weis' customers and creditors were third party beneficiaries of promises enforceable because of promissory estoppel, traditional principles of promissory estoppel would not entitle them to relief, for under such principles, only a promisee can invoke the doctrine to enforce a promise. *Dulien Steel Products, Inc.*

(footnote continued on next page)

Even assuming that there were promises to the NYSE, and that Weis' creditors and customers were such third party beneficiaries, they would not be entitled to enforce Claimants' fraudulently induced promises. Any rights which third party beneficiaries might have are derivative rights dependent upon the validity of the agreements which gave rise to them. Where the agreements are not enforceable by the promisee, because of fraud or otherwise, the third party beneficiaries have no rights to enforce them. *Sears, Roebuck & Co. v. Jardel Co.*, 421 F.2d 1048, 1055 at n. 21 (3d Cir. 1970); *Ted Spangenberg Co. v. Peoples Natural Gas*, 305 F.Supp. 1129 (S.D. Iowa 1969), *aff'd*, 439 F.2d 1260 (8th Cir. 1971); *Seigel v. Henry Fippinger, Inc.*, 264 App.Div. 203, 34 N.Y.S.2d 894 (1942); *General Acc. Fire & Life Assur. Corp. v. Margolis*, 116 N.Y.S.2d 209, 211 (Sup. Ct., Spec. T. 1952); 4 *Corbin on Contracts* §818 (1951); *Restatement of Contracts* §140. See discussion in Appellants' Brief at 38-43. The authorities cited at page 37 of Appellees' Brief stand merely for the general proposition that third party beneficiaries of a contract may enforce the contract in the absence of fraud, and they are therefore not applicable to this case.

Moreover, if Weis' customers and creditors had third party beneficiary rights, the Trustee could not enforce them. The Trustee asserts the capacity to enforce the alleged third party beneficiary rights of Weis' customers and creditors under Section 70c

(footnote continued from previous page)

v. Bankers Trust Co., 298 F.2d 836, 841-42 (2d Cir. 1962); *Allegheny Corp. v. James Foundation*, 115 F.Supp. 282, 297 (S.D.N.Y. 1953), *aff'd*, 214 F.2d 446 (2d Cir. 1954), *cert. denied*, 348 U.S. 913 (1955); *Restatement of Contracts* §90. *But see Restatement (Second) of Contracts*, §90 (Tent. Draft No. 2, 1965), criticized in *C. R. Fedrick, Inc. v. Sterling-Salem Corp.*, 507 F.2d 319, 322-24 (9th Cir. 1974).

Furthermore, the purpose of promissory estoppel is to avoid injustice and hardship to the relying party. See *Shinabarger v. United Aircraft Corp.*, 381 F.2d 808, 810 (2d Cir. 1967); 1 *Williston on Contracts* §140 (3d ed. 1957); *Restatement of Contracts* §90. Reliance by the NYSE, then, is not a predicate for enforcing the subordination agreements for the benefit of Weis' customers and creditors or for SIPC.

of the Bankruptcy Act and as "representative of the creditor body." (Appellees' Brief at 37) Claimants, of course, are also members of the "creditor body" and the Trustee understandably cites no authority for the proposition that he may choose to represent certain creditors' interests against the interests of other creditors. Under Section 70c of the Bankruptcy Act, the Trustee does have the rights of a judicial lien creditor at the filing date of the petition, but an innocent party's right to rescind a transaction with the debtor for fraud is superior to the Section 70c rights of the Trustee. *Federal's, Inc. v. Matsushita Electric Corp.*, [Current Binder] Bankr. L. Rep. (CCH) §66,399 (6th Cir. 1977); *In re Rhine*, 241 F.Supp. 86, *reh. denied*, 242 F.Supp. 127 (D. Colo. 1965); 4A *Collier on Bankruptcy* §70.41 (14th ed. 1976).

III. SUMMARY JUDGMENT IS IMPROPER BECAUSE THERE ARE GENUINE ISSUES OF MATERIAL FACT.

The District Court and the parties filing briefs in this Court supporting its decision have failed to address specifically the crucial question on a summary judgment motion—whether genuine issues of material fact exist. They have assumed facts not supported by or contradicted by the record and have ignored factual issues which do exist.

With respect to the argument that Claimants are estopped from rescinding because of the actual or presumed reliance of Weis customers and creditors, among the issues of fact are: (1) what are the functions and purposes of the net capital rule; (2) what did Weis' customers and creditors in fact look to for protection—the net capital of Weis and Claimants' subordination agreements, the accuracy of Weis' audited financial statements, the surveillance of Weis by the SEC and NYSE, or the insurance provided by SIPC; (3) what did Claimants know and expect concerning the validity of their loans in the event of fraud; and (4) what impact would elimination of the right to rescind for fraud have upon the availability of subordinated loans for brokerage

firms. With respect to the argument that Claimants made promises to or agreements with the NYSE, there are issues of fact such as: (1) whether Claimants made promises to or agreements with the NYSE; (2) whether the NYSE would have suspended Weis but for Claimants' subordination agreements; and (3) whether the NYSE's own actions disqualify it from asserting reliance. Pervading the entire case are serious questions of public policy, which the Supreme Court has warned should not be dealt with through summary procedures. See *Kennedy v. Silas Mason Co.*, 334 U.S. 249, 256-57 (1948).

The Trustee and SIPC suggest that, if this Court reverses and remands for trial, it should establish the procedures by which the case should be tried and should order that reliance by Weis customers and creditors be presumed. (Appellees' Brief 48-49) It is not necessary for this Court to address the procedural questions — those matters may be fully considered by the District Court and the Bankruptcy Court on remand. The issue in this Court is whether the Trustee's motion for summary judgment should have been granted. It may be that differences among Claimants (*e.g.*, as to the times their loans were made, their relationships with Weis, the materials upon which they relied) may dictate differences in treatment and order of proof in the trial court. In any event, proof of Weis' fraud should be expedited since it has been well documented in numerous forums.

CONCLUSION

The order of the District Court should be reversed, and this case should be remanded to the Bankruptcy Court for further proceedings consistent with its opinion of July 15, 1976.

July 1, 1977.

Respectfully submitted,

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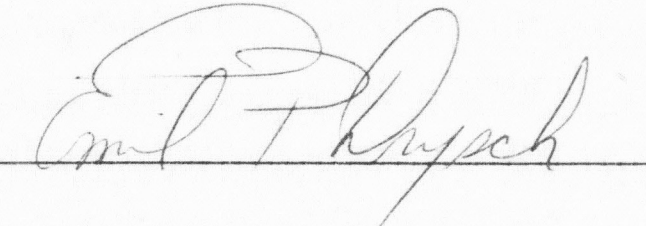
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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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In the Matter of Weis Securities, Inc., Debtor	)	
George Aldrich, et al, Appellants	)	
vs	)	No.
Edward S. Redington, Trustee,	)	77-6034
and Securities Investor Protection	)	77-6038
Corporation,	)	77-6040
	)	77-6045
Appellees.	)	77-6048
-----	)	77-6065

CERTIFICATE OF SERVICE

The undersigned hereby certifies that he served the enclosed Joint Reply Brief for Appellants by mailing two copies of the brief by first class mail, postage prepaid, to each of the persons named, at the addresses indicated, on the attached list on July 1, 1977.



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